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NOTES

OMISSION AND NONDISCLOSURE UNDER SEC RULE 10b-5: A DISTINCTION IN SEARCH OF A DIFFERENCE

I. Introduction

Ever since a private cause of action was implied¹ under section 10(b) of the Securities Exchange Act of 1934² and SEC Rule 10b-5 promulgated thereunder,³ courts have grappled with defining its

1. *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947), is credited with first implying a private cause of action. That a private cause of action exists is now "well established." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976). *But see* *Ross v. A.H. Robins Co.*, 465 F. Supp. 904 (S.D.N.Y. 1979) (if remedy exists under section 18 of the Securities Exchange Act of 1934 it is an exclusive remedy); *accord*, *Pearlstein v. Justice Mortgage Investors*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,760 (N.D. Tex. Oct. 17, 1978); *Kulchok v. Government Employees Ins. Co.*, [1977-1978 Transfer Binder] FED. SEC. L. REP. ¶ 96,002 (D.D.C. 1977).

2. 15 U.S.C. § 78j (1976). The pertinent part of the statute reads:

Manipulative and deceptive devices

It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national exchange—

....
(b) To use or employ, in connection with the purchase or sale of any security registered on a national security exchange or any security not so registered, any manipulative or deceptive device, or contrivance in contavention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

There is little legislative history of section 10(b), *but see* *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201-06 (1976), and reports cited therein.

3. 17 C.F.R. § 240.10b-5 (1978). The Rule provides:

Employment of manipulative and deceptive devices.

It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national exchange.

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

For the "legislative" history of the Rule see Freeman, *Conference on Codification of Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967).

elements. Because the Rule itself speaks in terms of fraud,⁴ the common-law actions of fraud and misrepresentation have been looked to for guidance.⁵

This Note begins with one of those elements: causation.⁶ Causation, in a common law action for misrepresentation, is typically shown by reliance;⁷ that is, by the plaintiff demonstrating that he relied upon the act of the defendant and was thereby harmed. In the context of Rule 10b-5, causation can be shown in terms of reliance, however an alternate theory has developed. In certain circumstances proof of materiality has substituted for reliance. This Note will show that, while there is disagreement among the circuits,⁸ causation is properly shown by materiality only if the fraud occurred because of the total nondisclosure, rather than the omission, of a material fact. Nondisclosure and omission shall be defined and distinguished⁹ and various courts' discussions thereof examined.¹⁰

II. The Language of the Rule

Rule 10b-5 is divided into three clauses. Clause one prohibits the employment of any device, scheme, or artifice to defraud.¹¹ The second clause is bifurcated. The first part is addressed to the making of untrue statements,¹² so-called "misstatements." The second part deals with omissions, making it unlawful to "omit to state a material fact necessary in order to make the statements in the light of the circumstances under which they were made, not misleading"¹³ Clause three, similar to clause one, is a broad prohibition of any act or practice which operates or would operate as a fraud or

The three clauses, (a), (b), and (c) are often called "(1), (2), and (3)." This Note will perpetuate the misnomers.

4. See clause one and three of the Rule note 3 *supra*.

5. See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744 (1975); *Holdsworth v. Strong*, 545 F.2d 687, 693-95 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *List v. Fashion Park, Inc.*, 340 F.2d 457, 461-62 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

6. In tort law this has been called, with minor variations, "cause in fact," W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 41 (4th ed. 1971) [hereinafter cited as PROSSER] or "legal cause" 3 *RESTATEMENT (SECOND) OF TORTS* § 548A (1977).

7. PROSSER, *supra* note 6, § 110, at 732; 3 *RESTATEMENT (SECOND) OF TORTS* § 537 (1977).

8. See pt. V *infra*.

9. See pt. III *infra*.

10. See pt. V *infra*.

11. See note 3 *supra*.

12. *Id.*

13. *Id.*

deceit.¹⁴ Additionally, clause three contains the "in connection with" requirement of a purchase or sale.¹⁵

Clause two is specifically addressed to omission and provides a rudimentary definition: an omission is the withholding of information in the context of statements already made. However, neither the Rule nor its underlying statute are directly addressed to the situation of total nondisclosure. Although most courts overlook the fact that the Rule is so divided, those that do not, hold that either clause one or three is broad enough to include nondisclosure.¹⁶

III. Omission and Nondisclosure Defined

Although the distinction between the clauses of the Rule itself indicates that omission is not the same as nondisclosure, more precise definitions are necessary.

A. Omission Defined

Properly, an omission is a deficiency. This follows not only from the language of the second clause of the Rule, but logically as well: something can be omitted only if something else has already been said.¹⁷ Generally, omissions can be of two types: those that cause a related statement,¹⁸ which has already been made, to become misleading; and those that are unrelated to a previous statement but are left out of a writing or other communication and tend to make the entire communication misleading.

It is well settled that material misstatements or omissions in a company's annual report will give rise to liability under the Rule.¹⁹ Therefore, as an example of the first type of omission, were a company to state in its annual report that the company had entered into

14. *Id.*

15. *Id.*

16. See, e.g., *Cochran v. Channing Corp.*, 211 F. Supp. 239 (S.D.N.Y. 1962). "The fact that defendants did not make any statements at all does not, in and of itself, deprive plaintiff of relief. The three subsections of Rule 10b-5 are in the disjunctive, and while subsection (2) seems to require a statement of some sort, subsections (1) and (3) do not." *Id.* at 243. See also *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951); 1 A. BROMBERG, *SECURITIES LAW: FRAUD* § 2.6(2) at 51 (1975 ed.) [hereinafter cited as BROMBERG]; 3 L. LOSS, *SECURITIES REGULATION* 1439 (2d ed. 1961) [hereinafter cited as LOSS].

17. 1 BROMBERG, *supra* note 16, § 2.6(2), at 51.

18. By "related statement" is meant a statement having to do with the same subject or transaction.

19. See, e.g., *Dillon v. Berg*, 326 F. Supp. 1214, 1231 n.27 (D. Del.) (citing *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969)), *aff'd*, 453 F.2d 86 (3d Cir. 1971).

a lucrative contract, without stating that one of the parties to the contract was in breach and performance was doubtful, it would be an omission.²⁰ While the company's statement that a favorable contract was entered into is literally true, it is misleading without the qualification.

As an example of the second type, if in the litigation portion of a company's annual report to the SEC a legal judgment²¹ against the company was not included, this too would be an omission. Note here that the judgments (or pending actions) which are reported are just as true without the omitted statement.

What makes both of these examples of withholdings omissions is the context in which they appear. The lack of information tends to make the entire document less accurate, or less true; hence the appellation "half-truths."²² Analytically, an omission can be seen simply as the other side of a misrepresentation.²³ Thus, a failure to include an expense item in an income statement could be considered either a misrepresentation of income or the omission of an expense item.²⁴

B. Nondisclosure Defined

Nondisclosure²⁵ is the total lack of a statement when there is an affirmative duty to speak.²⁶ The easiest example is an insider trading case. Under case law, a person who comes into possession of inside information pertaining to a stock is under a duty to either make the information public or abstain from trading in or recommending the stock.²⁷ Therefore, a broker who has such information,²⁸

20. This fact pattern is suggested by *Chelsea Assocs. v. Rapanos*, 527 F.2d 1266 (6th Cir. 1975). Under the circumstances of *Chelsea*, however, the withholding was treated as a non-disclosure. *Id.* at 1269-70.

21. It is assumed that the judgment was material.

22. See clause 2 of the Rule at note 3 *supra*.

23. 3 Loss, *supra* note 16, at 1434.

24. *Little v. First Cal. Co.*, 532 F.2d 1302, 1304 n.4 (9th Cir. 1976). "The categories of 'omission' and 'misrepresentation' are not mutually exclusive." *Id.*

25. A nondisclosure has also been called a "pure omission." Note, *The Nature and Scope of Reliance in Private Actions Under SEC Rule 10b-5*, 24 CASE WEST. L. REV. 363, 379-80 (1973).

26. See, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 154 (1972).

27. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

28. The analysis would be the same if it were the client with the inside information. See, e.g., *United States v. Chiarella*, 588 F.2d 1358 (2d Cir. 1978) (affirming imposition of criminal penalties for trading on inside information), *cert. granted*, 47 U.S.L.W. 3740 (U.S. May 15,

yet remains silent when a client asks him to trade in the stock, "commits" a nondisclosure upon execution of the trade.²⁹ Such fact patterns fit into a general paradigm of duty to speak coupled with total silence.³⁰

A nondisclosure, therefore, is identifiable only if the circumstances surrounding the withholding of the information are examined.³¹ For instance, a nondisclosure will rarely, if ever,³² occur in a transaction in which a writing is involved. In such a situation a withholding would be treated as an omission, for it would be the withholding of information under circumstances which would cause other statements in the writing, or the entire writing, to become misleading.³³ Therefore, the talisman for nondisclosure, is the duty to disclose.

IV. The Duty to Disclose

At early common law an action for misrepresentation would not lie for nondisclosure, because the law did not recognize liability for nonfeasance.³⁴ This harsh rule was mitigated by allowing an action if there existed a fiduciary, or other special relationship, between the plaintiff and the defendant.³⁵ Allowing the cause of action is only the beginning, however, for there remains a problem of proof. The plaintiff must still overcome the difficulty of demonstrating the casual nexus between defendant's nondisclosure, a "non-act," and

1979) (No. 78-1202). The result would be different at common law. There, a buyer may use special knowledge without incurring liability. See PROSSER, *supra* note 6, § 106, at 698.

29. See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 240 (2d Cir. 1974).

30. Cf. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963). In *Capital Gains* an action was brought pursuant to the Investment Advisor's Act of 1940, 15 U.S.C. §§ 80b-1 *et seq.* (1976), for "scalping." Scalping is a practice whereby a broker purchases stock for his own account prior to recommending the stock to clients. After the clients buy, the stock's price rises and the broker sells his own shares at a profit. Naturally the practice is not disclosed to clients. *Capital Gains* has been cited approvingly by the Court as an example of nondisclosure. *Sante Fe Indus., Inc. v. Green*, 430 U.S. 462, 474 n.14 (1977).

31. This is developed in pt. IV *infra*.

32. It is theoretically possible to have a nondisclosure in a transaction in which a writing is involved. If a purchaser in possession of inside information were to send a letter offering to buy shares at \$X, an unfairly low price, it might be a nondisclosure. Even here, however, the argument could be made that the letter contains a misrepresentation. It could be argued that an offer to buy at a certain price implies that it is a fair price.

33. See pt. III(A) *supra*.

34. PROSSER, *supra* note 6, § 106, at 696.

35. *Id.*

the harm suffered. Both problems were solved, in the Rule 10b-5 context, by the Supreme Court in 1972.³⁶

A. *Affiliated Ute Citizens v. United States*

In *Affiliated Ute* two bank officials perpetrated a fraud on a group of mixed-blood Indians.³⁷ Pursuant to the Ute Partition Act,³⁸ the Ute Indians divided, *inter alia*, oil and mineral rights in their reservation, and shares therein were distributed.³⁹ A bank near the residences of many of the mixed-blood Indians acted as transfer agent for the shares.⁴⁰ Two of the bank's officials induced some of the mixed-blood Indians to sell their shares. The mixed-blood Indians brought suit in federal district court against, *inter alia*, the bank and the two officials alleging violations of Rule 10b-5. The trial court found the defendants liable because (1) they misrepresented the fair market price of the shares and (2) they had not disclosed that they were making a market⁴¹ in the stock.⁴²

The United States Court of Appeals for the Tenth Circuit agreed that the officials had violated Rule 10b-5 by falsely representing to the plaintiffs that the price offered for purchase of the shares was the prevailing market price,⁴³ but absolved the defendants as to the allegation that the lack of disclosure of the bank's market making in the shares violated any duties owed to the plaintiffs. The court so held because the plaintiffs were unable to show any statement made by the officials upon which they had relied.⁴⁴

36. *Affiliate Ute Citizens v. United States*, 406 U.S. 128 (1972), *aff'g* 431 F.2d 1349 (10th Cir. 1970), and *aff'g in part & rev'g in part* *Reynos v. United States*, 431 F.2d 1337 (10th Cir. 1970). The Supreme Court's opinion will be referred to as *Affiliated Ute*.

37. Actually, the case involved more than this, but it is the Court's treatment of these two defendants that is of concern here. The Court's discussion of the facts is set out in 406 U.S. at 144-49. For a general discussion of the case, see Comment, *Affiliated Ute Citizens v. United States—The Supreme Court Speaks on Rule 10b-5*, 1973 UTAH L. REV. 119. The term "mixed-blood" is statutory, see note 38 *infra*, and is used here to be consistent with the statute and the Court's opinion. See 406 U.S. at 133 n.3.

38. 25 U.S.C. §§ 677-77aa (1976).

39. 406 U.S. at 134.

40. *Id.* at 146, 152.

41. A market maker is defined by SEC Rule 17a-9, 17 C.F.R. § 240.17a-9 (1978), as a dealer who holds himself out as being willing to buy and sell a particular stock for his own account.

42. 406 U.S. at 146-48. The trial court's opinion is not reported. However, its findings are set out in the Supreme Court's opinion in 406 U.S. at 145-49.

43. 431 F.2d at 1348.

44. *Id.*

On review, the Supreme Court agreed that the false statements as to the price of the shares were misstatements of a material fact and thus violated clause two of Rule 10b-5.⁴⁵ But more importantly, the Court held that, by not informing the plaintiffs that the bank was a market maker in the shares, the officials had violated the rule's prohibition against nondisclosure.⁴⁶

Such a prohibition, the Court held, is not found under clause two of the Rule, but rather under the first or third clause.⁴⁷ "To be sure, the second subparagraph of the rule specifies the making of an untrue statement of a material fact. The first and third paragraphs are not so restricted."⁴⁸ The making of a market in a stock was a fact that a reasonable investor might consider important and such activity on the part of the buyer could influence a decision whether to sell shares. Thus, such information was material.⁴⁹ "This being so, [the defendants] possessed the affirmative duty under the Rule to disclose this fact . . . to the sellers."⁵⁰ Plaintiffs' failure to show a statement by the defendants upon which they relied was not an obstacle to recovery for:⁵¹

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

The last sentence quoted is critical. In support of this statement the Court cited a circuit court opinion, *Chasins v. Smith, Barney & Co.*⁵²

Chasins offered a similar fact pattern to *Affiliated Ute*. Again, a dealer in securities failed to disclose to a customer the fact that the dealer was a market maker in the security.⁵³ The court stressed the

45. 406 U.S. at 152.

46. *Id.* at 152-53.

47. *Id.*

48. *Id.*

49. 406 U.S. at 152-53. The Supreme Court has refined the test of materiality from "might have considered" to "would have assumed actual significance." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

50. 406 U.S. at 153.

51. *Id.* at 152-53.

52. 438 F.2d 1167 (2d Cir. 1970).

53. *Id.* at 1169.

relationship between the parties. The plaintiff was the commentator on a radio program sponsored by the defendant,⁵⁴ and because of this relationship the plaintiff was sure to rely on information from the defendants.⁵⁵

Affiliated Ute, therefore, can be seen as standing for the proposition that in nondisclosure cases, properly brought under clause one or three of Rule 10b-5, reliance will be presumed,⁵⁶ once an obligation to disclose, and the nondisclosure of a material fact are shown.⁵⁷

B. The Nature of the Duty: The "Under the Circumstances of this Case" Requirement

The Court in *Affiliated Ute* began its holding on the causation issue with the phrase: "Under the circumstances of this case"⁵⁸ At least three facts in the case can be seen as important "circumstances." First, the bank officials and the plaintiffs were engaged in face-to-face transactions.⁵⁹ Second, the plaintiffs could be characterized as unsophisticated investors.⁶⁰ Finally, there existed a relationship between the plaintiffs and the bank officials such that the plaintiffs believed the bank officials were acting in their behalf.⁶¹ As the first and second criteria were probably neces-

54. *Id.* at 1169, 1172.

55. *Id.* at 1172; see also Nichols, *The Broker's Duty to His Customer Under Evolving Federal Fiduciary and Suitability Standards*, 26 BUFFALO L. REV. 435, 454 (1977). In fact, the court appeared to be more concerned with plaintiff's role as radio commentator than it was with defendants' violation of SEC Rule 15c1-4, 17 C.F.R. § 240.15c1-4 (1978). The rule requires disclosure to the customer of the broker's market maker status. "Market maker" is defined in note 41 *supra*.

56. The effect of the presumption, *e.g.*, is it rebuttable, shall not be discussed here. See Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 597-601 (1975).

57. *Accord*, *Fridrich v. Bradford*, 542 F.2d 307, 325 (6th Cir. 1976) (Celebrezze, J., concurring), *cert. denied*, 429 U.S. 1053 (1977); *Frigitemp Corp. v. Financial Dynamics Fund*, 524 F.2d 275, 282 (2d Cir. 1975). See also 3 Loss, *supra* note 36, at 1766. "[T]he duty to speak which is implicit in Rule (10b-5) arises in those circumstances where a fiduciary or quasi-fiduciary relation exists, where confidence is reposed or influence acquired, where there is a justifiable expectancy of disclosure or reliance upon the superior knowledge of another. . . ." *Id.* (quoting *Connelly v. Balkwill*, 174 F. Supp. 49, 59 (N.D. Ohio 1959)).

58. 406 U.S. at 153. One of the petitioners in *Affiliated Ute* urged the Court to eliminate reliance in all Rule 10b-5 cases. By beginning its holding as it did, the Court apparently rejected the argument. See Note, *The Nature and Scope of Reliance in Private Actions Under SEC Rule 10b-5*, 24 CASE WEST. L. REV. 363, 385 n.122 (1973).

59. 431 F.2d at 1348.

60. See Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 586 (1975).

61. 406 U.S. at 152-53.

sary to reach the third, it is the critical element. Further, at least one court has rejected the face-to-face requirement.⁶² Therefore, the initial inquiry for a court faced with a complaint that alleges fraud by nondisclosure is what "duty of disclosure the law should impose upon the person being sued."⁶³

For a duty to be found, a special relationship between the plaintiff and the defendant-nondiscloser must exist.⁶⁴ For example, if an individual were about to make a sizeable sale, in a thinly traded stock, which would affect the price of the stock, he need not make his intention to sell public,⁶⁵ for there exists no special relation between such seller and the public.⁶⁶

1. Broker-Dealers

As between brokers and their clients, however, a duty exists, at least if the broker is aware of inside information regarding the company;⁶⁷ if the broker is aware that a large purchase or sale is about to be transacted; or, if the broker is buying for his own account before recommending the stock to his clients.⁶⁸

Although courts rarely speak in terms of agency law when considering these questions, the situation where the client is buying a stock in which the brokerage house is a market maker can be analyzed in those terms. The broker is acting as an agent of the client when he purchases the stock and a principal when he sells from the brokerage house's account.⁶⁹ When an individual acts as an agent he is obligated to act just for the one principal or disclose precisely

62. *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 240 (2d Cir. 1974).

63. *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 363 (2d Cir.) (dictum), cert. denied, 414 U.S. 910 (1973).

64. Cf. PROSSER, *supra* note 6, § 106, at 696; 3 RESTATEMENT (SECOND) OF TORTS § 551 (1977) (both concerning tort law).

65. See Fleischer, Munheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 804 (1973).

66. If, however, the person were to acquire five per cent or more of the outstanding shares of a company there is a duty to disclose imposed by the Williams Act, 15 U.S.C. § 78m(d) (1976). The purpose of disclosure under the Williams Act is different than that under Rule 10b-5. Indeed, disclosure under the Williams Act must be made only after the purchase. *Id.*

67. *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 353 F. Supp. 264, 278 (S.D.N.Y. 1972), *aff'd*, 495 F.2d 228 (2d Cir. 1974).

68. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963); see also note 30 *supra*.

69. 3 Loss, *supra* note 16, at 1501-02; see also cases cited therein, especially Arleen W. Hayes, 27 S.E.C. 629 (1948), *aff'd*, 174 F.2d 969 (D.C. Cir. 1949).

what his role is.⁷⁰ The principal-agent relation is, axiomatically, a fiduciary relation.⁷¹

In the situations where the broker is not a market maker, the obligation to disclose will usually not arise if the broker is merely executing a sale or purchase at the direction of the client. Rather, it will arise in cases in which: (1) the client has vested the broker with discretion to make substantial investment decisions, thus acting as an agent;⁷² or (2) where, for other reasons, there exists a trust relation between broker and client giving the client reason to rely on the actions of the broker. Seemingly innocuous circumstances may give rise to this trust relationship. A duty to disclose has been found where a broker's client was a radio announcer on a program sponsored by the broker's firm.⁷³

2. *Common-law Fiduciary Relations*

The common law imposes a duty upon those in a fiduciary relation to disclose material information.⁷⁴ While finding such a relation could easily create a situation for nondisclosure, the Supreme Court has limited this approach by holding that there is no Rule 10b-5 liability for breach of a fiduciary duty, absent a showing of deception.⁷⁵ If this showing could be met, a fiduciary relationship presumably would qualify as a "circumstance" effective for requiring disclosure under the Rule.

3. *Agreements to Purchase or Sell Stock*

Stock buy-back arrangements have caused a plethora of litigation, probably because the seller later believes (correctly or incorrectly) that the purchaser would not have exercised the buy-back option if it was not advantageous. Although the agreement itself may explicitly place a duty to disclose upon the parties,⁷⁶ even ab-

70. W. SEAVEY, *HANDBOOK OF THE LAW OF AGENCY* § 150 (1964).

71. W. SELL, *AGENCY* § 2 (1975) (citing *Hobson v. Easton*, 399 F.2d 781 (6th Cir. 1968)); 1 *RESTATEMENT (SECOND) OF AGENCY* § 13 (1958).

72. See note 69 *supra*.

73. *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970). See also notes 54 & 55 *supra*.

74. PROSSER, *supra* note 6, § 106, at 697.

75. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977). See generally Note, *Suits for Breach of Fiduciary Duty Under Rule 10b-5 After Santa Fe Industries, Inc. v. Green*, 91 HARV. L. REV. 1874 (1978).

76. *Metro-Goldwyn-Mayer, Inc. v. Ross*, 509 F.2d 930, 933 (2d Cir. 1975).

sent such a provision a duty has been found. The cases often turn on the materiality of the purchaser's information.⁷⁷

In one case,⁷⁸ for example, a close corporation exercised a stock buy-back option from the estate of a deceased shareholder. Although the corporation was in negotiations to be taken over, which would presumably increase the price of its stock, this fact was not disclosed to the estate.⁷⁹ The estate brought suit against the corporation under Rule 10b-5, alleging nondisclosure.

In reversing a finding of liability, the appellate court explained that because the price at which the stock was to be bought back was fixed by a formula in the corporation charter, the take-over negotiations were not material.⁸⁰ However, in dicta, the court stated that there was a duty to disclose, but the duty was not violated because the information was not material.⁸¹

The implication to sales or purchases not governed by an agreement is clear. While formal tender offers, for example, are regulated by their own set of rules which require the disclosure of material information,⁸² certain private transactions are not so constricted. While one court has said that it is unnecessary for a potential purchaser to disclose information that would be against his own business interests,⁸³ the majority of courts require the disclosure if the information is material.⁸⁴

V. *Affiliated Ute's Progeny*

The lower courts have not applied *Affiliated Ute* uniformly. That a confusion exists is understandable as a result of the surface similarity in the words "omission" and "nondisclosure." At least three

77. See notes 79-84 *infra* and accompanying text.

78. Toledo Trust Co. v. Nye, 588 F.2d 202 (6th Cir. 1978).

79. *Id.* at 205.

80. *Id.* at 206-07.

81. *Id.* at 207 n.21. But see Villada v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 460 F. Supp. 1149 (S.D.N.Y. 1978) (information was material but court held no liability for nondisclosure); St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 562 F.2d 1040 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978).

82. Section 14(e), 15 U.S.C. § 78n(e) (1976), added to the Securities Exchange Act of 1934 by the Williams Act, is a broad anti-fraud provision.

83. Villada v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 460 F. Supp. 1149, 1150 (S.D.N.Y. 1978).

84. See, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970).

interpretations can be seen. The first group of cases either do not see a distinction between omission and nondisclosure and presume reliance in both, or acknowledge a distinction but hold that *Affiliated Ute* applies to both.⁸⁵ The second group makes a distinction between omission and nondisclosure and holds that the presumption should only be made in the latter case.⁸⁶ Finally, a few courts have held that the presumption is to be made in all Rule 10b-5 cases.⁸⁷ As this last view is in a distinct minority it shall not be considered further.

A. Omissions or Nondisclosures Presume Reliance

The application of *Affiliated Ute* to situations where fraud by omission is alleged can be seen in the Fifth Circuit's directive to a district court.

If the court determines that [the case before it] is a misrepresentation case, the more stringent reliance requirement would apply, and [the plaintiff] would have to prove he relied upon the defendants' misrepresentations. If, on the other hand, the district court determines that [it] is an omissions case, [the plaintiff] would be entitled to the *Ute* presumption of reliance. . . .⁸⁸

That the Fifth Circuit was speaking of omissions as that term has been defined here is clear: the omissions in the case occurred in the context of a company's financial statements.⁸⁹ Problematically, the court also refers to the omissions as "misstatements."⁹⁰

85. See, e.g., *Holmes v. Bateson*, 583 F.2d 542, 558 (1st Cir. 1978); *Rifkin v. Crow*, 574 F.2d 256, 263 (5th Cir. 1978); *Forrestal Village, Inc. v. Graham*, 551 F.2d 411, 414 (D.C. Cir. 1977) (dictum); *Blackie v. Barrack*, 524 F.2d 891, 905 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1977); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 381 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1976); *Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 482 F.2d 880, 884 (5th Cir. 1973); *Frankel v. Wylie & Thornhill, Inc.*, 55 F.R.D. 330 (W.D. Va. 1972). See also 5 H. NEWBERG, CLASS ACTIONS § 8824b, at 883 (1977) (*Affiliated Ute* virtually eliminates any requirement for proof of individual reliance in class actions).

86. See, e.g., *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713, 717 n.2 (8th Cir. 1978); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112, 127 (S.D.N.Y. 1974), aff'd on this point, 540 F.2d 27 (2d Cir. 1976); *Cutner v. Fried*, 373 F. Supp. 4, 12 (S.D.N.Y. 1974); see also note 57 *supra*.

87. See, e.g., *Carras v. Burns*, 516 F.2d 251, 257 (4th Cir. 1975) (*Affiliated Ute* applies to cases of misrepresentation or nondisclosure); *Sullivan v. Chase Inv. Servs.*, 79 F.R.D. 246, 261-62 (N.D. Cal. 1978) (misrepresentations). For earlier cases, see those cited in Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 588 n.22 (1975).

88. *Rifkin v. Crow*, 574 F.2d 256, 263 (5th Cir. 1978).

89. *Id.* at 258.

90. *Id.* at 263. The court's use of the term probably was inadvertent. Or was it? It can be argued that the fraud alleged really was one of misstatement or misrepresentation. The Ninth Circuit interchanged words in a similar context. See note 108 *infra* and accompanying text.

In support of its interpretation of *Affiliated Ute* the First Circuit relied, *inter alia*, upon a Ninth Circuit case.⁹¹ The case may be regarded as the leading exponent of the view that *Affiliated Ute* is applicable to omissions. It is worthwhile to examine this case in some detail and then to contrast it with two other cases which come to a different result.⁹² Finally, the underlying rationale of these three opinions will be examined.⁹³

In the Ninth Circuit case, *Blackie v. Barrack*,⁹⁴ a class action was instituted against a company, its officers and directors, and the company's independent auditors,⁹⁵ on behalf of all those who purchased the company's stock during a certain period. The complaint alleged that the purchasers were defrauded because the stock's price was artificially inflated.⁹⁶ This inflation was allegedly due to false statements in the company's annual and interim reports, press releases, and SEC filings.⁹⁷ Upon motion, class certification was granted by the district court.⁹⁸ Some of the defendants appealed, arguing in part, that individual questions of reliance by members of the class, precluded class treatment.⁹⁹

The Ninth Circuit held that proof of "subjective" reliance¹⁰⁰ was unnecessary where a plaintiff's claims "are, or can be, cast in omission or non-disclosure terms. . . ."¹⁰¹ For support, the court cited *Affiliated Ute*.¹⁰² Stating what is called a "fraud on the market" theory, the court explained that in situations involving widely traded stocks, once materiality is shown, causation is shown "more

91. *Id.* at 263 n.4 (citing *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976)). *Blackie* is discussed immediately *infra*.

92. *See* pt. V(A) *infra*.

93. *See* pt. VI *infra*.

94. 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

95. 524 F.2d at 894.

96. *Id.* at 902.

97. *Id.* (quoting the complaint).

98. Pursuant to FED. R. Civ. P. 23. The court's discussion of certification is set out in 524 F.2d at 900-11.

99. *Id.* at 905.

100. "Subjective reliance" is the court's term for individual reliance. 524 F.2d at 905. *See also* note 111 *infra*. It is probably derived from what has come to be called the subjective/objective distinction in causation. Subjective causation is shown when it is demonstrated that the plaintiff relied on the acts or omissions of the defendant. Objective causation is shown once materiality has been demonstrated. *See* H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 9.21 (rev. ed. 1977).

101. 524 F.2d at 905.

102. *Id.*

likely than not. . . ."¹⁰³ Reliance is eliminated from the formulation for, given materiality, some traders in the market must have relied on the company's false reports, thus causing the stock's price to rise artificially.¹⁰⁴ In the situation before it, the court stated that requiring proof of reliance "directly . . . impose[d] an unreasonable and irrelevant evidentiary burden"¹⁰⁵ on the plaintiffs. Thus, class certification was proper, and the case was remanded for trial.¹⁰⁶

There are two analytical difficulties with *Blackie*. First, as was developed earlier,¹⁰⁷ *Affiliated Ute's* presumption of reliance is not properly invoked when the fraud alleged is one of omission rather than nondisclosure. Second, even assuming *Affiliated Ute* is applicable to omission, the facts as presented by the court do not indicate that the defendants were guilty of omission or nondisclosure, but rather misrepresentation. In fact, the court itself used that term at one point.¹⁰⁸

Nothing, so far as is discernible from the court's recitation of the facts, was left out of any of the company's written reports. Instead, the defendants were alleged to have misrepresented the true financial picture of the company,¹⁰⁹ by: overstating earnings, inventories, and other assets; "burying" certain expense items; failing to write-off certain assets; failing to establish adequate reserves for receivables; and, misrepresenting the company's prospects for future earnings.¹¹⁰ If the complaint is to be believed nothing was omitted, save the truth.¹¹¹

103. *Id.* at 906 n.22.

104. *Id.* at 904.

105. *Id.* at 907.

106. Unfortunately the case never did go to trial. Unfortunate, because it would have been interesting to see how the trial court would have dealt with the individual issues of reliance in terms of awarding damages. The Ninth Circuit felt this would be "virtually a mechanical task." 524 F.2d at 905.

While a writ of certiorari was being sought, most of the parties entered into a provisional settlement agreement which required the defendants to pay approximately \$7.75 million. Supplemental Brief of Petitioners at 3, *Blackie v. Barrack*, 429 U.S. 816 (1977) (No. 75-1258) (denying certiorari), reprinted in 1A SECURITIES CASES DENIED CERTIORARI (Securities Regulation Series) at 27 (1976/1977). After denial of the writ the agreement presumably went into effect.

107. See text accompanying note 57 *supra*.

108. 524 F.2d at 894.

109. *Id.*

110. *Id.* at 902.

111. A more recent panel in the Ninth Circuit had more of a problem with reliance than did the *Blackie* panel. *Little v. First Cal. Co.*, 532 F.2d 1302 (9th Cir. 1976). The court was

Moreover, nowhere did the court make an inquiry into the existence of any duty to disclose. There was no showing of a special relationship, the "under the circumstances of this case,"¹¹² that the Court found in *Affiliated Ute*. The Eighth Circuit, in considering a similar factual situation to *Blackie*, reached a decidedly different result.

B. Only Nondisclosures Presume Reliance

In *Vervaecke v. Chiles, Heider & Co.*,¹¹³ a hospital revenue bond purchaser, attempting to represent all the purchasers of the bonds, brought suit against those associated with the offering and one of the brokerage houses from whom he purchased. Plaintiff alleged that the offering statements covering the bonds were fraudulent.¹¹⁴ On motion for summary judgment, defendants demonstrated that the plaintiff had not received the offering statement prior to purchasing the bonds.¹¹⁵ Thus, they argued, plaintiff could not have relied on any statements made therein. The trial court agreed and granted defendants' motion.¹¹⁶

On appeal to the Eighth Circuit, the plaintiff-appellant, relying in part on *Blackie v. Barrack*,¹¹⁷ argued that his complaint alleged fraud by omission, misstatement, and nondisclosure, and therefore *Affiliated Ute's* presumption of reliance should be applied.¹¹⁸ Specifically, he alleged that the offering statement did not state, *inter alia*, (1) the speculative and risky nature of the bonds, and (2) an accurate financial picture of the hospital authority,¹¹⁹ and claimed that such a withholding of information was a nondisclosure within

faced with an alleged fraud involving the sale of subordinated capital notes. It was alleged that certain information was not disclosed to the purchasers. Such a sale, the court held, could not fit within *Blackie's* "fraud on the market" theory. *Id.* at 1304 n.3. The court explained that because the defendants had made some general representations proof of "individual" reliance should be required. *Id.* at 1304 n.4. This presented a "dilemma" for it might be found that the plaintiffs who had relied would not have a sufficient stake in the matter to prosecute their claims; but to obviate proof of reliance might force defendants to compensate plaintiffs who had not relied. *Id.* The court did not resolve the dilemma.

112. 406 U.S. at 152-53. See also notes 58-60 *supra* and accompanying text.

113. 578 F.2d 713 (8th Cir. 1978).

114. *Id.* at 717.

115. *Id.* at 718, 720.

116. *Vervaecke v. Chiles, Heider & Co.*, No. 76-0-423 (D. Neb. Aug. 29, 1977).

117. 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

118. Brief for Appellant at 25, 26 & Reply Brief for Appellant at 9, 10, *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713 (8th Cir. 1978).

119. Brief for Appellant, *supra* note 118, at 8.

the meaning of *Affiliated Ute*.¹²⁰

The Eighth Circuit rejected this argument saying the thrust of the complaint was fraud by way of material misrepresentations and omissions.¹²¹ The court explained that "misrepresentations, and omissions in the nature of misrepresentations (misleading statements, half truths), are appropriately considered alike in this case under 10b-5(2)."¹²² As *Affiliated Ute* spoke to situations of nondisclosure, it was not applicable to the case at bar.¹²³ Therefore, the defendants' demonstration of a lack of reliance was sufficient to carry a motion for summary judgment, and the trial court's ruling was affirmed.¹²⁴

Upon this finding, the Eighth Circuit held that the district court's refusal to certify a class action was also proper, as the plaintiff, subject to the unique defense of a lack of reliance, would be an inadequate class plaintiff.¹²⁵ The thrust of *Vervaecke* becomes even clearer if the analysis of an earlier district court case is examined.¹²⁶

In *Herzfeld*, the action, again, was based upon allegedly misleading financial statements reported on by independent auditors.¹²⁷ The district court rejected the plaintiff's argument that the complaint alleged nondisclosure suitable for a presumption of reliance:¹²⁸

It is of no moment that the misrepresentation in part resulted from failure to disclose material facts. We think the case no different from an accountant's false report of a company's earnings, a clear case of misrepresentation, because, in either case, the accountant makes representations which he knows are untrue. [*Affiliated Ute*], therefore, which was grounded on a mere nondisclosure unaccompanied by any representation whatever, is inapposite.

This statement is similar to the Eighth Circuit's observation in *Vervaecke*, of "omissions in the nature of misrepresentations. . . ."¹²⁹

120. *Id.* at 24.

121. 578 F.2d at 717.

122. *Id.* at 718 n.4.

123. *Id.*

124. *Id.* at 720.

125. *Id.*

126. *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112 (S.D.N.Y. 1974), *aff'd in part & rev'd in part*, 540 F.2d 27 (2d Cir. 1976).

127. 378 F. Supp. at 117.

128. *Id.* at 127.

129. 578 F.2d at 717 n.2; see also notes 121-23 *supra* and accompanying text.

VI. Conclusion

Thus, a distinction can be seen between omission and nondisclosure. Under the proper circumstances,¹³⁰ in the case of nondisclosure, a presumption of reliance should be made. To presume reliance in those situations is compelling, and furthers the purpose of the Rule, for, as a practical (or logical) matter, in the case of nondisclosure, it would be virtually impossible for a plaintiff to demonstrate reliance when nothing was said.¹³¹

In contradistinction, the presumption is properly not afforded when the complaint alleges a material omission. In this situation a defrauded plaintiff should be able to come forward with a document,¹³² or evidence of a conversation, and establish that something, but not all, was said. Moreover, to relieve the plaintiff of a showing of reliance in omission situations might allow recovery further than policy dictates. As is often said, Rule 10b-5 is meant to deter fraud not provide insurance for every purchaser of securities.¹³³ People purchase and sell securities for a myriad of reasons, only one of which may be the inspection and analysis of documents issued by the offering company. To allow recovery to a plaintiff who never read the document, much less relied upon it, eliminates the causal nexus between the act of the defendant and the harm suffered by the plaintiff.¹³⁴

The Ninth Circuit's holding in *Blackie v. Barrack*,¹³⁵ essentially eliminated the reliance requirement in class actions under the Rule.¹³⁶ As was developed above,¹³⁷ the court should not have relied upon *Affiliated Ute* in so doing. Additionally, other authority relied upon by the court can be seen as weak.¹³⁸ If the Ninth Circuit's

130. See pt. IV(B) *supra*.

131. 2 BROMBERG, *supra* note 16, § 8.6(1), at 209.

132. E.g., an annual report, a private placement memorandum, or one of the various periodic financial statements required by the SEC.

133. See, e.g., *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.) (aim of Rule is to qualify doctrine of *caveat emptor*, not establish scheme of investor's insurance), *cert. denied*, 382 U.S. 811 (1965).

134. See, e.g., *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040, 1048 (8th Cir. 1977) (without proof of causation defendant could be liable to all the world), *cert. denied*, 435 U.S. 925 (1978).

135. 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

136. 5 H. NEWBERG, CLASS ACTIONS § 8824b, at 883 (1977).

137. See text accompanying notes 108-11 *supra*.

138. For instance, aside from the interpretation of *Affiliated Ute*, the court quoted from the *Advisory Committee's Note on Federal Rule of Civil Procedure 23* thus: "[A] fraud

decision is seen as making new law based upon policy considerations, the policy has been embraced by some,¹³⁹ and rejected by others.¹⁴⁰

The better view is that *Affiliated Ute* is only applicable to cases of total nondisclosure. Not only is this view consistent with the facts of *Affiliated Ute*, but it is in harmony with the current philosophy of the Supreme Court to contain development in the area of the securities laws in general¹⁴¹ and Rule 10b-5 in particular.¹⁴²

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perpetrated on numerous persons by the use of similar misrepresentations may be an appealing situation for a class action. . . ." 524 F.2d at 903. However, the court did not quote the next sentence of the Note which states: "On the other hand, although having some common core, a fraud case may be unsuited for treatment as a class action if there was material variation in the misrepresentations made or in the kinds or degrees of reliance by the persons to whom they were addressed." *Proposed Amendments to Rules of Civil Procedure*, 39 F.R.D. 69, 103 (1966).

139. See, e.g., *Rifkind v. Crow*, 574 F.2d 256, 263 (5th Cir. 1978); see also Stoll, *Reliance as an Element in 10b-5 Actions*, 53 ORE. L. REV. 169, 179-82 (1974). Mr. Stoll formulates three categories where reliance will be presumed, viz.: (1) nondisclosure actions, (2) affirmative misrepresentation cases if brought as class actions, and (3) tender-offers, shortform mergers, or manipulated market prices. *Id.* at 181.

140. See, e.g., *Lorber v. Beebe*, 407 F. Supp. 279 (S.D.N.Y. 1975). There the court stated as to *Blackie's* presumption in class actions: "This seems to us an untenable position. A class of valid claims cannot be created by aggregating a host of invalid ones." *Id.* at 289 n.7. *Accord*, *Gelman v. Westinghouse Elec. Corp.*, 73 F.R.D. 60 (W.D. Pa. 1976), *appeal dismissed*, 556 F.2d 699 (3d Cir. 1977). The district court denied class certification and declined to distinguish *Blackie*, stating: "[As to the] Ninth Circuit's preference for a different result, I simply and respectfully disagree." *Id.* at 65 n.4.

141. See, e.g., *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977) (denying standing to defeated tender offeror to sue for money damages); *TSC Indus., Inc. v. Northway Inc.*, 426 U.S. 449 (1976) (redefining materiality); *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412 (1975) (declining to imply private action under the Securities Investor Protection Act of 1970).

142. See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (requiring scienter in private damage action under Rule 10b-5); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 423 (1975).